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No. 07-221

IN THE

Supreme Court of the United States

STAFF IT, INC.,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF OF THE TAX FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether federal courts should consider all facts and circumstances outlined in Treasury Regulations when determining if "reasonable cause" exists to justify abatement of penalties for an employer's failure to pay payroll taxes under 26 U.S.C. § 6651(a)(2), or its failure to deposit payroll taxes under 26 U.S.C. § 6656(a).

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INTEREST OF THE *AMICUS CURIAE*

The Tax Foundation submits this brief as *amicus curiae* in support of Petitioner in the above-captioned matter.[1]

The Tax Foundation is a non-profit research

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioner and Respondent have been obtained and filed with the Clerk of the Court.

organization founded in 1937 to educate taxpayers about sound tax policy. To this end, we disseminate information on taxes and promote tax systems that are simple, fair, and conducive to economic growth. The Tax Foundation works to further this mission by educating the legal community on issues relating to tax law, by explaining tax law concepts to lawmakers and the public in an understandable and relevant manner, and by advocating that judicial decisions on tax law promote principled tax policy. Accordingly, the Tax Foundation has a direct stake in the outcome of this case.

STATEMENT OF THE CASE

Petitioner Staff IT, Inc., engaged in the business of hiring and paying technical contractors, and staffing them to outside business clients. These clients would pay Petitioner for the services. In 2001, the dot-com crash and the collapse of Enron triggered a severe economic downturn, particularly in Houston, where Petitioner encountered reduced demand for its contractors. Petitioner's financing company also declared bankruptcy.

It was at this time that Petitioner failed for three quarters to file, pay, and deposit payroll taxes as required by federal law. Petitioner did not scale back expenses until early 2002 when new financing was arranged. The company stabilized its finances by the end of 2002 and resumed required tax payments. However, the IRS pursued penalties, which are the subject of this appeal.

Petitioner presented a request to abate the penalties, which an IRS Appeals Officer denied. Petitioner then commenced suit in the District Court, which granted summary judgment for the government. *See United States v. Staff IT, Inc.*, 2006 WL 314440 (S.D. Tex. Feb. 9, 2006). In March 2007, the United States Court of Appeals for the Fifth Circuit affirmed. *See Staff IT, Inc. v. United States*, 482 F.3d 792 (5th Cir. 2007).

SUMMARY OF ARGUMENT

Employers have an obligation to withhold payroll taxes from employees' wages and forward them to the federal government, and failure to do so properly subjects the employer to penalties. But the statute imposing this obligation allows for abatement of penalties where there has been no "willful neglect" and where the failure was due to "reasonable cause," which in turn is defined as "undue hardship."

Rather than engaging in an analysis of all facts and circumstances faced by the taxpayer, so as to determine whether there existed "willful neglect" and "undue hardship," the lower court in this case instead held that where a taxpayer fails to fire employees and cease all payments to creditors, he cannot claim "reasonable cause" or "undue hardship." This severe test is in conflict with four circuit courts of appeal, ignores the congressional purpose, and effectively reads the "reasonable cause" exception out of the statute.

Four circuit courts have held that serious financial hardship can constitute "undue hardship" justifying, in some circumstances, abatement of penalties. They have reached that result by relying on the text and on the congressional purpose, which was to deter willful failure to pay tax obligations without taking a "scorched earth" approach that forces troubled businesses to close, thus eliminating jobs, destroying investment, disrupting the economy, and ultimately, reducing tax collections.

The conduct of the Petitioner in this case, especially the failure to file, may ultimately exclude it from the benefit of the penalty abatement. But this Court should grant the petition because Petitioner is correct in arguing that the lower court used an improperly narrow test that is in conflict with the statute. If a corporation facing potential financial ruin can never be considered to have

"reasonable cause" under the statute until it fires all employees and stops all payments to creditors, the exception is virtually meaningless. This Court's guidance is needed to resolve the circuit split on this issue and to prevent harm to small businesses. The statute and regulations at issue apply nationally, and by holding that a diligent employer facing undue financial hardship—where paying the taxes necessarily means closing the business—can have penalties abated, this Court can apply a uniform standard based on the text and purpose of the statute. If the test applied by the court below stands, troubled small businesses who owe taxes and creditors will end up paying neither. This is a result that benefits no one, and a result that Congress sought to avoid.

ARGUMENT

I. THIS COURT'S GUIDANCE IS NEEDED TO APPLY A UNIFORM STANDARD BASED ON THE STATUTORY TEXT AND PURPOSE, AND PREVENT THE HARM AND UNCERTAINTY RESULTING FROM AN ACKNOWLEDGED CIRCUIT SPLIT.

Under the text of the statute and regulations, an otherwise diligent taxpayer facing undue hardship can have penalties abated in certain circumstances. Because the test used by the court below to ascertain "undue hardship" is in conflict with the text and the statutory purpose, the petition should be granted to prevent harm and uncertainty and resolve the acknowledged split in the circuit courts of appeal.

A. An otherwise diligent taxpayer facing undue hardship can have penalties abated in certain circumstances, under the text of the statutes and regulations.

The federal government requires that employers withhold 6.2 percent of an employee's wages for Social Security payroll taxes, and a further 1.45 percent for Medicare payroll taxes. *See* 26 U.S.C. § 3101. These so-called "trust fund taxes" must be forwarded to the IRS, and an employer who fails to do so can be made personally liable, even in bankruptcy. *See* 26 U.S.C. § 6672(a); 11 U.S.C. § 523(a)(1)(A). In addition to the 7.65 percent in trust fund taxes, employers have the legal obligation to pay to the IRS a further 7.65 percent "employer match." *See* 26 U.S.C. § 3111.

Federal law imposes three major sets of penalties on employers who are late in their payroll tax obligations. Late filing of payroll taxes, or failure to file, is subject to a 5 percent per month penalty up to a 25 percent maximum. *See* 26 U.S.C. § 6651(a)(1).[2] Late payment of payroll taxes, or failure to pay, is subject to a 0.5 percent per month penalty up to a 25 percent maximum. *See* 26 U.S.C. § 6651(a)(2). Late deposit of payroll taxes, or failure to deposit, is subject to a 10 percent penalty if the deposit is more than 15 days late. *See* 26 U.S.C. § 6656(b).

The statute provides that the penalties do not apply in certain situations. *See* 26 U.S.C. § 6651(a)(2) (penalty for failure to pay or late payment added "unless it is shown that such failure is due to reasonable cause and not due to willful neglect"); 26 U.S.C. § 6656(a) (penalty for failure to deposit or late deposit added "unless it is shown that such

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[2] Petitioner does not contest the penalty for late filing. The court of appeal failed to address whether this fact is relevant for a "willful neglect" inquiry.

failure is due to reasonable cause and not due to willful neglect"). *See also* 26 U.S.C. § 6656(a)(1) (penalty for failure to file or late filing added "unless it is shown that such failure is due to reasonable cause and not due to willful neglect").

Under the statute, taxpayers must show that there is both "reasonable cause" and the absence of "willful neglect,"[3] so a judicial understanding of these terms is central to determination of penalty cases. "Reasonable cause" with respect to failure to pay is defined in the Treasury Regulations:

> A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either *unable to pay the tax or would suffer an undue hardship* (as described in Sec. 1.6161-1(b) of this chapter)[4] *if he paid on the due date.* In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, *consideration will be given to all the facts and circumstances of the taxpayer's financial situation*, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such

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[3] "Willful neglect" is neither defined in the Regulations, nor was it addressed by the court of appeal.

[4] The referenced section states that undue hardship "means more than an inconvenience to the taxpayer." *See* 26 C.F.R. § 1.6161-1(b). The regulation gives the example of selling a property at a sacrifice price on the tax due date.

> expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax.

26 C.F.R. § 301.6651.1(c) (emphasis added). The regulation addressing late deposit, 26 C.F.R. § 301.6656, does not define reasonable cause, but courts (including the court below in this case) have applied the same "undue hardship" and "all the facts and circumstances" test, from the late payment regulation, in such situations. *See, e.g., Staff IT,* 482 F.3d at 800; *Fran Corp. v. United States*, 164 F.3d 814, 816 (2d Cir. 1999); *East Wind Indus., Inc. v. United States*, 196 F.3d 499, 504 (3d Cir. 1999).

As a practical matter, the statutes and Treasury Regulations only require the exercise of ordinary business care and prudence, not the exercise of extraordinary or retrospectively perfect care and prudence. As such, the statutory and regulatory text provide that after a court considers all relevant facts and circumstances, it may order abatement of penalties where a taxpayer is not guilty of willful neglect and would have reasonably suffered an undue hardship by paying or depositing payroll taxes on time.

B. The test used by the court below to determine "undue hardship" conflicts with the regulatory text, congressional purpose, and the conclusions of other courts.

Instead of applying an "all facts and circumstances" approach, the Fifth Circuit focused on whether specific acts of conduct occurred. The court held that unless a taxpayer has fired "enough" employees, and if the taxpayer has "favored" creditors over the government, the taxpayer's conduct can never amount to reasonable cause.

The court did note that the regulations instructed consideration be given to all facts and circumstances of

the taxpayer's financial situation. *See Staff IT*, 482 F.3d at 799. However, the court declined to adopt the test. *Id.* at 800 ("We . . . need not—and therefore do not—resolve this issue today."). Instead, the court applied a dispositive analysis of only two factors:

> [T]he jurisprudence reflects that the primary factors in determining whether a taxpayer exercised ordinary business care are (1) the taxpayer's favoring of other creditors over the government, which weighs against a finding of reasonable cause, and (2) the taxpayer's willingness to decrease expenses and personnel, which weighs in favor of a finding of reasonable cause.

Id. at 801. Therefore, in the view of the lower court, unless a taxpayer (1) ends all payments to all creditors *and* (2) fires "enough" employees, the taxpayer's non-compliance will be considered to have been due to willful neglect and not reasonable cause.

Neither the regulations nor the statute require that "enough" employees must be fired for reasonable cause to exist. The court does not provide authority for its conclusion. *Fran Corp.*, to which the court cites in a footnote, does not discuss the firing of employees, but rather "lavish or extravagant" entertainment expenses. *Fran Corp.*, 164 F.3d at 820. Courts can, of course, consider staffing levels as part of a consideration of all facts and circumstances in the case. But the lower court's dispositive focus on whether people were fired, while declining to consider other facts or circumstances, has no basis in the law.

The other element of the Fifth Circuit test, whether a taxpayer favors other creditors over the government, guarantees that no taxpayer suffering financial hardship can ever prevail. When a business continues to operate

but defaults on its tax obligations, other creditors *necessarily* are favored over the government. Even a taxpayer who pays only those expenses necessary for staying in business would fail the Fifth Circuit's test. The Fifth Circuit understands the harshness of this test, but pointed to the importance of preventing businesses from escaping their tax obligations. "To conclude otherwise would be to sanction S.I.'s unilateral, self-execution of a government loan." *Id.* at 801-02.

Preventing businesses from engaging in such conduct is certainly very important, but it is a policy choice to which Congress has created an important exception. While the default position is to impose penalties on those who fail to deposit and pay payroll taxes, the "reasonable cause" and "willful neglect" provisions in the statute show Congress's expectation that there are situations where penalties will be abated. Under the Fifth Circuit test, where a business must end all payments to all creditors and must fire "enough" employees, a business must necessarily go out of business. "Under this approach, no one benefits. Where, however, a taxpayer keeps its business operating at a minimal level in order to collect monies contractually due so that it can pay trust fund taxes and other debts . . ., the economy and the federal fisc, including the IRS, benefit." *East Wind Ind.*, 196 F.3d at 509.

The implicit Fifth Circuit test closely resembles the explicitly adopted test of the Sixth Circuit Court of Appeals in *Brewery, Inc. v. United States*, 33 F.3d 589 (6th Cir. 1994). There, a business failed to deposit and pay payroll taxes after suffering lost business due to a nearby bridge construction project. *See id.* at 591. The court held that use of the withheld taxes for business purposes automatically precluded a finding of reasonable cause. "[S]ince the trust fund taxes are for the exclusive use of the government, the use of trust funds for the payment of other creditors cannot, as a matter of law,

constitute reasonable cause for abating the penalties assessed. . . ." *Id.* at 592.

The *Brewery* rule has been heavily criticized by four other circuit courts of appeal. These cases, particularly the later ones, have acknowledged the split in authority and explicitly declined to follow the *Brewery* rule. In *Diamond Plating Co. v. United States*, 390 F.3d 1035, 1038 (7th Cir. 2004), the Seventh Circuit concluded that financial hardship can justify abatement of penalties, referring to appellant's argument that the company "would have been forced out of business or into bankruptcy if it had paid the 1998 and 1999 employment taxes." *Id.* at 1038. *See also id.* ("We agree with the majority of circuits that have considered this issue, and recognize that financial hardship may constitute reasonable cause for abatement of penalties for nonpayment of taxes in some circumstances."). However, after reviewing all relevant facts and circumstances, *see id.* at 1038-39, the court concluded that Diamond Plating's non-compliance did not stem from reasonable cause. Specifically, the company had paid its taxes during its financial low point in 1996, and failed to do so in better times in 1998-99 primarily because of a deceptive accountant. Because the company paid its arrears immediately after the deception became known, "[this] suggests that the company had an available source of credit in times of financial difficulty. In light of these facts, no reasonable jury could find that Diamond Plating's financial situation excused its failure to pay employment taxes in 1998 and 1999." *Id.* at 1039. Nevertheless, the *Diamond Plating* court explicitly rejected the *Brewery* rule and held that financial hardship can constitute reasonable cause for abatement of penalties.

In *Van Camp & Bennion v. United States*, 251 F.3d 862 (9th Cir. 2001), the Ninth Circuit also considered and rejected the *Brewery* rule. The trial court had refused to

consider any conduct outside of eight IRS-listed situations as reasonable cause, a ruling the Ninth Circuit considered "clearly erroneous." *Id.* at 867. The court ruled that if a business must choose between paying taxes and staying in business, it can constitute reasonable cause. "The need to reject *Brewery*'s bright line rule is illustrated by the facts of this case. . . . If the potential ruin of a corporation is not relevant, then the reasonable cause exception is virtually meaningless." *Id.* at 868. The court remanded the case to the trial court for determination of all facts and circumstances, including the business's financial problems. *See id.* at 867-69.

In *Fran Corp.*, the Second Circuit held that the "regulations clearly require a factual assessment of the taxpayer's financial situation to determine whether it has exercised ordinary business care and prudence in responding to competing financial obligations." *Fran Corp.*, 164 F.3d at 819. Application of the test includes ascertaining whether expenses made in lieu of paying due taxes were necessary to sustain the business. "[T]hese expenditures support the district court's finding that they were 'lavish or extravagant' because the preservation of the business did not require them to be made. *Id.* at 820, *citing* 26 C.F.R. § 301.6651-1(c)(1). Responding to the *Brewery* rule, the Court rejected the view that financial distress can never amount to undue hardship. "To hold otherwise would effectively read out of the statute the 'reasonable cause' exception to mandatory penalties in many employment tax cases." *Id.* at 819.

In *East Wind Ind.*, the Third Circuit held that if a review of all facts and circumstances demonstrate that the business would necessarily have closed had payment of taxes occurred when due, even if other creditors received payments, reasonable cause exists justifying abatement of penalties:

> The evidence shows that if the Taxpayers had paid their employment taxes when due,

> they would have had insufficient funds to pay the reduced work force and essential creditors to enable them to remain a going concern. . . . Under these facts and circumstances, we find that the Taxpayers have established that undue hardship would have resulted if they had paid their employment taxes on time.

East Wind Ind., 196 F.3d at 509-10.

The *East Wind* court also stated some of the reasons underlying the congressional decision to permit abatement of penalties. "The IRS has consistently taken the position that if a taxpayer cannot afford to pay trust fund taxes, no matter what the cause, it should close up shop. Both the economy and the federal fisc are negatively impacted by such an approach—the amount of money flowing into the economy and the fisc is reduced as a result of increased unemployment, idle buildings and plants, and decreased sales of goods and services." *Id.* at 509. The rule applied by the Fifth Circuit, that a business suffering financial hardship must end all payments to all creditors and must fire "enough" employees in order for there to be "reasonable cause" justifying abatement of penalties, undermines this congressional purpose and is in conflict with the statute, regulations, and the conclusions of four sister circuits.

C. The petition should be granted so as to provide guidance and prevent harm and uncertainty.

The statute and regulations at issue apply nationally and have long existed. "The 'reasonable cause'/willful neglect' standard has been a part of the penalty provisions of the tax statutes since 1916, and Congress has not amended these provisions to create a different standard for the failure to pay trust fund taxes. . . ." *Fran*

Corp., 164 F.3d at 818. The regulatory language describing the "all the facts and circumstances" test, 26 C.F.R. § 301.6651-1, and the consideration of "undue hardship," 26 C.F.R. § 1.6161-1(b) have existed since 1973. Substantial reliance exists on the statute and regulations being upheld by the IRS and by courts.

In the Sixth Circuit and now the Fifth Circuit, troubled small businesses who owe taxes and creditors now face an unenviable set of options. They can pay their taxes, and if that necessarily means closing the business, investment will be lost, employees fired, and capital idled. This is despite congressional awareness of the sad irony of using penalties to collect Social Security and Medicare taxes on behalf of employees who are then terminated. Alternatively, a business facing undue financial hardship can keep the doors open, but to qualify for abatement of penalties, it must refuse to pay all creditors and begin firing employees. Most if not all businesses in financial distress will be unable to qualify for the abatement specifically granted by Congress.

In four other circuits, an otherwise diligent employer who faces the choice of paying taxes or closing his business can have penalties abated in certain circumstances. Following the letter of the statute and regulations, the court must examine all relevant facts and circumstances in making this determination. The presence or absence of any one element is not dispositive or conclusive.

Therefore, the meaning of a federal statute and federal regulations intended to have national scope will vary by region. Instead of the uniform application anticipated by Congress, troubled businesses will face harsher treatment in the Fifth and Sixth Circuits than elsewhere, making business investment potentially less profitable there than in other circuits. This harm is particularly unjustified when considering the text and purpose of the statute and regulations.

This Court should grant the petition to resolve this circuit split, remedy this uncertainty and uneven application of a national law, and uphold the congressional text and the meaning and purpose behind it. Although this Petitioner's conduct in failing to file may be relevant for denying it an abatement, such a conclusion can occur only after application of the proper comprehensive test. The court below did not do so, and instead adopted an improperly narrow test that forces troubled small business to close, depriving creditors of what they are owed, depriving employees of their jobs, depriving investors of their returns, disrupting the economy, and ultimately, depriving the government of future tax revenue. This harm is a result that benefits no one, and a result that Congress sought to avoid.

CONCLUSION

For the foregoing reasons, *Amicus* respectfully requests that this Court grant the petition for writ of certiorari.

Respectfully submitted,

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